

Tax Aspects of Equity Compensation

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I. STOCK OPTIONS - Two major categories: statutory and non-statutory.

A. Statutory or Qualified Stock Options.

1. Those options offered under Sections 421-424 of the Internal Revenue Code of 1986 (I.R.C.). Incentive Stock Option (ISOs) or "Qualified Options."

- a) A statutory or qualified stock option plan for a corporate employee to purchase company stock at a price for a period of time.
- b) "ISOs" receive favorable tax treatment upon meeting statutory requirements.

B. Nonstatutory or Nonqualified Stock Options (NSOs).

- 1. Stock options that do not meet the statutory requirements of Sections 421-424.
- 2. NSOs are taxed under the rules of Section 83 and its regulations.
 - a) Governed by general principles of taxation including case law, rulings and Section 83.

II. Stock Purchase Plan, Employee Stock Purchase Plan (ESPPs) or "423 Plan."

A. A statutory or qualified plan offering employees an opportunity to purchase company stock at a discount

- 1. Can be as much as 15%
- 2. Favorable tax treatment.

III. Restricted Stock Options or Restricted Stock.

A. Either a qualified or nonqualified stock option or stock subject to restrictions such as the requirement to sell stock to the employer at a predetermined price upon termination of employment.

- 1. Restricted Property. Employers providing stock options or stock for employees commonly impose additional restrictions on the option or the stock.
 - a) E.g., employee required to sell stock back to the employer upon termination of employment at the price paid for the stock or at a formula price.
 - (1) The restrictions affect valuation and the timing of recognition of income.

IV. Statutory Requirements for ISOs. Section 422, requirements follow.

A. May only be granted to an employee.

B. May be granted by the employer corporation (or parent, or subsidiary).

C. Must be granted Pursuant to a written Plan.

1. The Plan must specify the total number of shares authorized for issuance and the (class(es) of) employees eligible for the options.
2. Shareholders must approve the Plan.
3. Plan must require grant of the options within 10 years of adoption of the plan.
4. The Plan may contain additional provisions not inconsistent with these requirements.

D. Each Option Agreement must

1. specify in writing the restrictions on exercise, the option price and the time for exercise,
2. require exercise within 10 years from date of grant,
3. require that the employee must exercise the option while employed or within three months after termination of employment.
 - a) Where termination is due to disability, the three-month period is extended to one year.

E. ISOs cannot be granted at less than the fair market value of the stock.

1. If the employee owns more than 10% of the total voting power of the corporation or its parent or subsidiary, the option price must be not less than 110% of the fair market value of the stock at time of grant and the option may not be exercisable more than 5 years from date of grant.

F. The option cannot be transferred (except by will or laws of descent). (The option agreement must state this limitation.)

G. The option cannot be exercised by anyone other than the employee during the employee's lifetime, or after the employee's death by his executor, beneficiary or an heir of the employee's estate.

H. To the extent that the sum of all statutory options under all plans for an individual that become exercisable in a year exceeds \$100,000, the options in excess of \$100,000 cease to be ISOs and will be treated as nonstatutory options.

1. This is determined by using the fair market value of the stock subject to the options on the date of grant of the respective options.

V. Nonstatutory Stock Option UTORY STOCK OPTION ("NSO") Requirements.

A. General . Section 83 and its regulations govern the taxability of NSOs.

1. Generally, NSOs generate ordinary (compensation) income on the bargain element or spread.
 - a) Income realization may occur
 - (1) as early as the grant date (if the option has a readily ascertainable fair market value), or

(2) later upon exercise of the option, or

(3) even later upon removal of certain restrictions if such are applicable to the stock acquired upon exercise.

b) The company granting the option obtains a corresponding income tax deduction at the time the optionee realizes income.

c) Eligibility. NSOs may be granted to non-employees and frequently are granted to a variety of service providers, such as directors, vendors, independent contractors, financing entities, etc.

VI. ESPPs. Governed by Section 423 of the IRC.

A. They also provide advantageous tax treatment.

1. They may allow employees to purchase stock at a discount.

2. Limit the ordinary (compensation) income and obtain capital gain treatment on the balance of the gain on the disposition of the stock.

3. If the holding period requirements are satisfied, the employee's ordinary income treatment will be limited to the lesser of

a) the difference between the fair market value of the stock and the option price at the time of grant or

b) the difference between the fair market value of the stock and the option price at the time of disposition.

c) Any further gain is capital gain.

4. The same result applies to the disposition of stock by an employee's estate, beneficiary or heir except that the special holding periods are waived.

5. If the employee realizes less than the option price on sale, he or she has no ordinary income, and the loss is long-term capital loss if the holding period was met.

6. If the holding period was not met, the employee realizes ordinary (compensation) income on the difference between the fair market value of the stock and the option price at date of exercise.

7. There are nine statutory requirements, similar those applicable to ISOs, in I.R.C. Section 423(a)(1) -(9).

a) However, they differ in that

(1) the option price can be less than (but not less than 85% of) the fair market value of the stock on the date of grant,

(2) the option period is shorter for discounted stock options,

(3) the grant must be non-discriminatory (with certain exclusions),

(4) grants to 5% owners are prohibited, and

(5) annual dollar limitations on purchases apply.

VII. Tax Consequences of Option Grants to (1) Employees and (2) Employers

A. Depend upon

1. the type of option (statutory v. nonstatutory),
2. the restrictions applicable to the options and/or option stock and
3. valuation rules.

B. On the Grant of the Option.

1. ISOs and ESPPs.

a) Upon the grant of an ISO or ESPP option,

- (1) Employee realizes no income, and
- (2) Employer does not qualify for a deduction.

2. NSOs

a) Upon the grant of an NSO, the person who performed services for which the NSO was granted

(1) realizes compensation income upon the grant of an NSO only if the option has a "readily ascertainable value."

(a) In that case, the grantee will realize compensation income under the general rules of Section 83(a) (and Reg Section 1.421-6) to the extent of the spread (the fair market value of the option less the amount paid for the option, if any).

(b) Any further gain or loss will be capital.

(2) if the option lacks a readily ascertainable value upon grant, the taxability will be established under the general rules of Section 83(a) and (b) (and Reg. Section 1.421.6).

(1) at the time of exercise or

(2) upon disposition of the option.

(3) Generally, options to purchase non-publicly-traded stock do not have a readily ascertainable fair market value unless transferable, exercisable immediately in full, the property subject to the options (and the options) do not have restrictions or conditions that significantly affect the fair market value of the options, and the fair market value of the option privilege is readily ascertainable (which it is

generally not if it is not traded on an established exchange).

C. On the Exercise of the Option.

1. ISOs and ESPPs.

a) An employee realizes no income upon the exercise of an ISO.

(1) The employee exercising an ISO may be subject to the Alternative Minimum Tax (AMT).

(a) The spread when the stock becomes freely transferable or not subject to a substantial risk of forfeiture is includible in alternative minimum taxable income.

(b) If stock acquired through the exercise of an ISO is sold in the same year as the exercise, the sale is a "disqualifying disposition," and the general rules of Section 422(c)(2) apply and limit the amount of AMT adjustment to the excess of the amount realized on the sale of the stock over the employee's basis in the stock.

b) The employer receives no deduction.

2. NSOs.

a) Optionee's Compensation Income. The spread between the fair market value of the stock and the exercise price on the exercise of an NSO (or upon lapsing of a restriction) is compensation income.

b) Employers must treat this amount as "wages" for employees or "self employment income" for non-employees

c) Valuation.

(1) Publicly-Traded Stock.

(i) If the stock is publicly traded, fair market valuation is generally easy to determine.

(2) Privately Held Stock.

(i) Fair market value is determined by the usual principles applied in valuing privately held stock.

(3) Restrictions.

(i) All restrictions other than permanent, non-lapsing restrictions are ignored.

(a) Non-lapsing restrictions that involve (a) a substantial risk of forfeiture or (b) a

restriction on transferability of the stock result in postponement of recognition of income until the restrictions lapse.

(b) If stock is subject to any other non-lapse restriction, the recipient is taxed upon receipt of the stock; the non-lapse restriction merely affects the fair market value of the stock.

(c) If there are restrictions that lapse or terminate upon the passage of time or occurrence of specific events, ("Lapse Restrictions"), the exercising recipient is taxed when the restriction lapses.

(1) The recipient's basis equals the exercise price plus the amount of income inclusion on lapse. The holding period begins upon the earlier to occur of (1) the property becoming transferable, (2) when the property is no longer subject to a substantial risk of forfeiture or (3) after a 83(b) election has been made.

(2) Lapse restrictions fall into two categories:

(a)
Substantial
Risk
of
Forfeiture
(including

those
imposed
by
law,
such
as
restrictions
under
Section
16(b)
of
the
Securities
Exchange
Act
of
1934).

(b)
Nontransferability.

(3) The property
is taxable when
the Lapse
Restrictions
lapse, or on the
first of the lapse
of transfer or
risk of forfeiture
restrictions if the
property is
subject to both.

d) Section 83(b)
) Election.

(1)
The
recipient
of
the
property
upon
exercise
may
make
an
election
under
Section
83(b)
to
include
the
difference
between
the

fair
market
value
of
restricted
property
over
the
amount
paid
for
the
property
in
the
year
in
which
the
property
is
transferred.

(a)
The
election

(i)
Is
irrevocable
without
the
consent
of
the
Internal
Revenue
Service,

(ii)
Must
be
made
within
30
days
of
the
transfer

(iii)
Will
limit
the
ordinary
income
recognized

to
the
amount
stated
above,
and
any
additional
gain
or
loss
will
be
capital.

(iv)
However,
no
loss
deduction
is
allowed
upon
subsequent
forfeiture
of
the
property;
only
the
excess
of
the
amount
paid
over
any
amount
realized
upon
the
forfeiture
may
be
deducted
(usually
as
a
capital
loss).

e) Withholding

(1)
Income
Taxes.
Income

taxes
will
be
due
upon
exercise
of
an
NSO,
or
upon
the
lapse
of
a
restriction
on
restricted
stock
received
upon
exercise,
equal
to
the
spread,
or
on
a
disqualifying
disposition
of
stock
acquired
by
exercise
of
a
statutory
option.

(2)
The
employer
is
required
to
withhold
on
exercising
NSOs
or
upon
lapse
of
the

restrictions.

(3)
Withholding
on
ISOs
is
not
required.

f) Social
Security and
Self-Employment
Taxes (SET).

(1)
Social
security
and
self-employment
taxes
also
apply
to
the
spread
on
an
NSO.

g) Reporting.

(1)
Employer
Statement
-ISOs.
Employers
transferring
ISO
stock
to
employees
upon
exercise
must
furnish
the
employee
with
a
statement
by
January
31
of
the
year

following
exercise
containing
detailed
information
for
future
tax
reporting.

(2)
Deemed
Inclusion
Rule.
If
employers
timely
file
and
include
income
on
Form
W-2
for
employees
or
Form
1099-Misc.
for
non-employees,
the
"deemed
inclusion
rule"
allows
the
employer
to
treat
the
recipient
as
if
they
included
the
income
for
the
year
and
as
a
result,
the

employer
can
deduct
the
amount
in
calculating
its
income
taxes.

(3)
For
Non-Employees
payors
file
Form
1099-Misc..

(4)
Payors
file
Form
IO99-Misc.

(5)
Financial
and
Accounting
Standards.

(a)
The
Financial
and
Accounting
Standards
Board
establishes
specific
rules
and
guidelines
for
reporting
transactions
involving
stock
compensation.

D. Sale of Option Stock.

1. ISOs.

- a) An employee is taxed upon the disposition of the option stock.
- b) A disposition includes any sale, exchange, gift or transfer of legal

title of the option stock.

c) Holding Periods.

(1) The holding period determines the character of the gain from the sale of the option stock.

(a) Qualifying Dispositions (statutory). If the stock is sold after the later of two years from the date of receipt of the option or one year from the date of the receipt of the shares, the gain (or loss) will be capital gain equal to the difference between the sale proceeds and the option exercise price.

(b) Disqualifying Dispositions. If the holding period is not met, the employee will recognize ordinary income equal to the difference between the fair market value of stock at the time of option exercise and the option price and capital gain equal to the difference between the disposition proceeds and the fair market value of the stock on date of exercise.

(2) Basis -Dual Basis.

(a) For ISOs, the holder can have two basis figures, one for regular income tax purposes and another for AMT purposes.

2. NSOs

a) See (B)(2)(a)

3. ESPPs. Same rules on disposition as for ISOs, except that if ESPP allowed discount on purchase, discount may be subject to ordinary income taxation upon disposition of acquired stock. On sale of the stock, ordinary income exposure is limited to the lesser of the spread between the option price and fair market value of the stock (i) at the time of the grant or (ii) at the time of the sale of the stock. Any excess gain is capital.

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